Throw out the bathwater, not the baby

Guest Column
MARC MOGULL

The movement of property investors into central and eastern Europe in recent years has been a bit like failed military campaigns in Russia – begun with visions of glory (despite questionable rationales), and characterised by inadequate understanding of the risks. With the region's property markets now turning dramatically, the journey home for investors, poetically timed with a harsh European winter, will be the financial equivalent of Napoleon's 1812 retreat.

The pain varies by country and sector, but the theme of an endeavour gone horribly wrong is largely the same. Amidst this carnage a couple of questions need answering: how did we get here, and what happens next?

Several factors played a role in the unjustifiable rise and merciless fall in CEE commercial property values. The first is investment market liquidity (or lack thereof). The joke goes "an emerging market is a market you can't emerge from in an emergency". Too right. Few acknowledged that these markets bore the hallmarks of an AIM-listed stock: small capitalisation, few ground rules, minimal transparency and no committed institutional investor base.

Second is the lack of any meaningful supply constraints. Without these, overbuilding and falling rents and values are inevitable. Balderdash to those who put their faith in regional economic growth as a panacea – just like those who overpaid for offices in the US sunbelt twenty years ago. Blinded by trends, both groups lost sight of cycles and ignored the basic principles of supply and demand.

Factor three was a failure to assess and price macroeconomic risks, not least currency risk. Many didn't understand the nuanced nature of currency risk exposure, falling into the trap of believing that a rent tied to the Euro or Dollar constituted an effective hedge. It didn't and it doesn't.

Culprit four was a failure to understand and evaluate weaknesses in legal, regulatory, institutional and corporate governance frameworks. Even where advisers can point to a rulebook, they'll rarely state confidently how this will be interpreted or enforced. The "custom and practice" implicitly relied on in investors' home markets is absent or ill-formed in the region. Weak laws, regulations, institutions and enforcement leave chasms of opportunity for locals to teach foreign investors the difference between *de jure* and *de facto* power.

The fifth factor that drove "CEE-mania" was investors' strange attraction to markets they don't understand. In Rumsfeld-speak, call it the lure of unknown-unknowns. As property markets rise, investors become uncomfortable with conditions in their home markets, so they look abroad. The CEE region seemed an ideal place. The "known-knowns" – strong growth, a love of cash-bearing foreigners and locals keen to speak English – were unequivocally positive. A review of the "known-unknowns" (diligencing a foreign market through your own lens) also produced a thumbs-up. Unlike at home, however, the "unknown-unknowns" were legion; but ***these were unlikely to get surfaced***. The result was bad decisions taken by inexperienced investors justified by flawed processes.

The last factor is the predictable tightening of yields at the end of a bull market, as investors compromise investment criteria to sustain returns. Chasing income helped erode the yield differential between CEE markets and western Europe in recent years, though the prophets would attribute it only to "growth prospects". Sadly, the prophets (and their followers) overlooked liquidity and currency risk, institutional weaknesses and a host of other issues. They'll now pay the price.

So what next? Investment demand in the region will dry up, financing will evaporate, prime yields will widen to 8-10% (higher still in Russia/Ukraine) and secondary assets will become virtually unsellable. As asset values collapse geared funds and listed property companies will fold, be taken over by lenders, or survive as zombies to recover value for the banks.

For those pondering what to do now, I'd suggest looking at past market corrections, in Europe or the US. People active in the region will talk up the markets until there's no-one left to talk (or to talk to). Take advantage of that. Sell early. Whatever the bid, hit it. Yields will keep rising, and you won't get a better offer next year.

On the buy-side, be patient. This downturn will be severe and sustained. There will be distressed sellers everywhere. Most importantly, don't repeat previous mistakes: understand the macroeconomic issues affecting each country; think about currency risk; focus on replacement cost; pick the right partners; get the due diligence right; and remember that what you don't know ***can*** hurt you.

As in all downturns, markets will over-correct, so the opportunity to profit will be there. Prime assets are where you'll want to be, as secondary assets may never recover. Yield differentials ***within*** the region will widen, and stay wide for years. Yes, the region will go through an economic rough patch, but that's cyclical. While it's dangerous to be blinded by trends, it's equally dangerous to lose sight of them. Long term, this part of Europe will outperform so, as we throw out the bathwater, it's worth keeping hold of the baby.